Evergreen State Bank
Financial Solutions

February 15, 2011

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Proposed Rule on Debit Card Interchange Fees, Docket No. R-1404; RIN No. 7100 AD63

Debit card transactions have become the most popular non-cash means of purchasing goods and services in the United States.

Millions of consumers and thousands of merchants benefit from the debit card infrastructure that has been developed at a great cost to banks and credit unions.

Rather than encouraging the continued development and use of debit card transactions, the Proposed Rule goes well beyond the requirements of the Durbin Amendment and would disrupt the market process with a hard price cap on interchange fees. This would severely curtail the growth of one of the most popular and efficient means of transacting day-to-day purchases for American consumers.

Fed's Proposed Rule Implementing the Durbin Amendment:

The Durbin Amendment authorizes the Board to establish interchange fee standards that largely preserve the benefits of the debit card payment system by enabling issuers to recover a broad array of their costs plus a reasonable rate of return.

The statute does not require the Board to cap interchange fees, nor does it require the Board to restrict fees to issuers' incremental costs of authorization, clearance and settlement.

To the contrary, the statute requires the Board to establish *"standards for assessing"* whether an interchange fee "*is reasonable and proportional to ... the cost incurred by the issuer with respect to the transaction.*" The Board misconstrues this requirement in three crucial respects:

– First, the Board fails to accept the normal meaning of "standards for assessing" which connotes an evaluative process, and instead reads this phrase as requiring predetermined caps.

Stoughton Office: *207 South Forrest Street, PO Box 427, Stoughton, WI 53589-0427 • 608.873.6681 • Fax: 608.873.6920*
Lake Kegonsa Office: *3162 County Road B, PO Box 427, Stoughton, WI 53589-0427 • 608.873.2010 • Fax: 608.873.0527*
Sun Prairie Office: *2580 Ironwood Drive, Sun Prairie, WI 53590-8820 • 608.837.2911 • Fax: 608.837.2924*
Janesville Office: *2701 North Pontiac Drive, Janesville, WI 53545-0397 • 608.373.9800 • Fax: 608.373.9810*
www.evergreenstatebank.com

Evergreen State Bank
Financial Solutions

- Second, the Board interprets "reasonable and proportional" to modify "costs," rather than "fees," contrary to the clear statutory language.

- Third, contrary to the Board's view, Durbin does not prohibit the consideration of incremental costs beyond those associated with authorization, clearance or settlement of a particular transaction.

By applying the phrase "reasonable and proportional" to costs, the Board fails to give effect to the courts' long-standing construction of similar phrases, such as "just and reasonable," in ratemaking schemes to require the inclusion of all costs and a reasonable rate of return, in large part to ensure such statutes conform to constitutional norms.

The Proposed Rule thus raises serious constitutional concerns to the extent it is likely to preclude issuers from recovering their costs, plus a reasonable rate of return. The Proposed Rule's suggestion that issuers can increase costs to consumers to make up for the loss of revenue from merchants is far from demonstrable, and, in any event, it does not address the constitutional flaws in the Proposed Rule. The Board has an obligation to avoid constitutional issues, not create them.

Impact on Consumers:

Interchange fees enable banks and credit unions to provide millions of consumers with a variety of free debit card products and services, including free checking (bank accounts are estimated to cost banks $250-$300 annually per customer),[1] free debit cards, free debit card transactions and fraud protection on debit card transactions. The Proposed Rule will sharply reduce the collection of debit interchange fees, and thus lead to several unintended, undesirable and unreasonable consequences for consumers.

Banks and credit unions will likely be forced to eliminate free debit card services and products and free or low-cost checking accounts for millions of Americans. Loss of these services and products will be particularly devastating for low-income Americans who, without debit interchange fees, would not qualify for free checking and will either need to start paying higher fees or be forced out of the mainstream banking system to check cashers and non-bank sources of lending.

The Proposed Rule will make debit cards less desirable for those customers who remain able to obtain them. For example, interchange fees are often higher for larger purchases to compensate for the risk of higher fraud losses on such purchases. By imposing a price cap that fails to let issuers recover their costs, and especially their costs for larger purchases, the Proposed Rule may force issuers to limit a customer's use of a debi[illegible] to purchases below a certain dollar amount in order to avoid higher fraud losses [illegible] of that, because the Proposed Rule drastically lowers interchange fees, debit [illegible] also will have fewer resources to invest in services and products that consum[illegible] such as customer service, anti-hacking and other technologies to protect th[illegible]

1 *The Cost of a Checking Account*, ABA, June 2010, http://www.aba.com/aba/docume[illegible] /press/CostofCheckingAccountsJune2010.pdf.

their systems, and the development of new programs and methods of payment.
The Proposed Rule will force banks and credit unions into three basic choices—all of which are contrary to sound public policy:

- Banks and credit unions could be forced to suffer a loss on every debit interchange transaction.

- Banks and credit unions could be forced to substantially scale back or terminate their debit card programs, something that the Federal Reserve itself has previously acknowledged in opposing the adoption of government price control statutes by Congress. The burden of this choice would fall disproportionately on low-income Americans who depend on debit cards to transact a substantial portion of their purchases. To the extent that debit card programs survive the Proposed Rule, innovations (such as different payment methods) will be stifled.

- Banks and credit unions could be forced to seek to recoup some of the lost revenues by charging for various debit card-related products and services that are now offered free of charge, such as free debit cards, free debit card transactions and free checking accounts. These actions would again place a disproportionate burden on lower income Americans.

Impact of Price Controls:

Price controls are disruptive because they almost inevitably lead to unintended and harmful consequences and market inefficiencies. In this situation, the negative consequences and distortions are eminently predictable, widespread and serious.

Consumers will bear the brunt of the Proposed Rule, with the benefits accruing mainly to the largest retailers in the form of a windfall wealth transfer that could exceed $12 billion.

- Banks and credit unions cannot operate debit programs at a loss and will have no option but to try to recover costs in other ways, including through fees on depositors and limiting or eliminating services that are now provided free or at low cost.
- Any benefits to consumers are highly speculative. Merchants are not required to pass on any cost savings, and experiences in foreign markets suggest that they will not. Furthermore, small merchants may see little benefit due to the bundled pricing they are typically charged by merchant acquirers, with the gains accruing almost solely to the very largest retailers.

Small banks and credit unions, though nominally exempt from the specific legal restriction on interchange fees, are nevertheless likely to be harmed significan[illegible] the reduction of their interchange fees as the markets and payments infrastru[illegible] to pressures generated by the Proposed Rule.

Evergreen State Bank
Financial Solutions

The debit card payment system itself also will suffer. Barred from recovering through interchange the costs of maintenance and innovation of the system, such expenditures are likely to be reduced, stifling future investment and innovation that would benefit consumers and merchants and reduce the risk of system failures and security breaches. Likewise, the general availability and specific benefits of the current debit card payment system, including debit availability for high-transaction amounts or for certain kinds of transactions (e.g., Internet), may be eliminated or curtailed, potentially in favor of higher risk payment methods (e.g., cash and check).

Network Participation Restrictions:

The Board's interpretation of the Network Exclusivity Restrictions exceeds or contradicts statutory authority. The adoption of Alternative B will cause unnecessary and avoidable harm to the debit marketplace and consumers through a multitude of unintended and negative consequences.

– Adoption of Alternative B will (a) present networks and issuers with significant technical challenges and financial burdens, including the replacement or reprogramming of millions of merchant terminals, as well as substantial changes to software and hardware for networks, issuers, acquirers and processors in order to build the necessary systems capability; (b) stifle innovation and inhibit the development and deployment of new authorization methods and technologies; and (c) may spur greater consolidation within the debit network market, ultimately resulting in less competition and less choice for all participants.

– Alternative B also would result in unprecedented changes to the nation's payments infrastructure and require every debit card issuer – as many as 16,000 banks and

credit unions under the current landscape – to reissue all 507 million debit cards in the United States.

– Alternative A provides merchants with adequate transaction routing choices except where merchants have voluntarily elected not to support multiple methods of transaction authorization (e.g., not deploying PIN pads).

– Emerging payment technologies, such as mobile payments and biometrics, should not be subject to the statute's network exclusivity restrictions. For the foreseeable future, all consumers with a payment-enabled mobile phone also will have a traditional plastic debit card, thus preserving choice to consumers and merchants. A regulatory requirement to fragment mobile payment volume across multiple networks will undermine this nascent market and will stifle new innovative technologies.

Call to Action:

Given the serious flaws in the Proposed Rule, we urge the Board to wit

nstatebank.com

Evergreen State Bank
Financial Solutions

proposal, fundamentally revise its overly narrow interpretation of the Durbin Amendment and issue a new proposed rule that takes fully into account both the requirements of law and the significant public policy considerations at stake.

Supporting Points/Fiscal Impact:

From the Federal Reserve Board's commentary, total industry debit interchange revenue in 2009 was $16.2 billion.

If all transactions for all issuers are priced at $0.12, industry revenue will fall to $4.4 billion, a decline of $11.8 billion.

If interchange pricing to smaller issuers (under $10 billion in assets) does not change, industry revenue will drop to approximately $8.3 billion.

If interchange rates for many large issuers cluster around the safe harbor rate of $0.07, then total industry revenue will drop to approximately $3.3 billon, an 80 percent reduction.

Thank you for your time and consideration.

Sincerely,

Bonnie K Smithback

Bonnie K. Smithback
Deposit Operations – Debit Card